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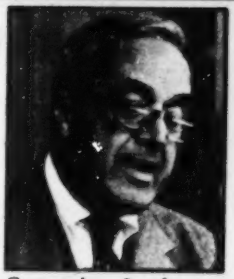

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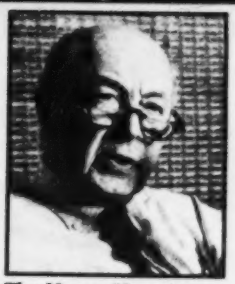

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For companies that can't create a good earnings record the hard way, there is a new fad in managing earnings. It's called . . .

Equity earnings

Statistical Spotlight

MANAGEMENTS ONCE AGAIN have found a way to get more smoke out of their earnings chimneys even though there isn't much fire in their stoves. The smoke—smoke screen might be a better term—comes from what accountants call equity earnings. Equity earnings are profits earned by another company but carried on your P&L statement as well as on the other company's.

To oversimplify, it works like this: Suppose you own 100 shares of General Motors. In 1979 GM earned $10.04 a share and paid out $5.30 in dividends. As a shareholder you received $530. But you wanted to make your income statement look good and you decided to report your

How much smoke? How much fire?

The reported earnings for the latest fiscal year of the 48 companies listed below reflect equity interests in yet other companies. As the accompanying story makes clear, there is a lot of difference between "equity interest" and cash in hand.

Investor—Investment (% of shares owned)	Equity in earnings/losses: total (mil)	Equity in earnings/losses: per investor's share	Investor's net income: total (mil)	Investor's net income: per share	Equity in earnings as % of total net	Recent price of investor's stock	Price/earnings ratio: based on total earnings	Price/earnings ratio: excluding investment
Aetna Life & Casualty—Geosource (32%)	$ 5.2	$0.06	$ 559.5	$ 6.93	1%	31⅞	4.6	4.6
Alexander & Baldwin—Pacific Resources (21)	1.7	0.19	35.3	3.89	5	29½	7.6	8.0
Allegheny Ludlum—			71.5	7.30	NA	31⅛	4.3	NA
Liquid Air-N Amer (33)	8.1*	1.09*						
Wilkinson Match (44)	5.7	0.77						
AMAX—Adobe Oil & Gas (30)	2.8E	0.05	368.1	6.54	1	55⅜	8.5	8.5
American Financial—			86.1	9.16	14	30½	3.3	4.0
Fairmont Foods (27)	1.6	0.21						
United Brands (28)	6.9	0.89						
DSI (20)	0.5	0.06						
N American Mtge (36)	–1.3	–0.16						
Mission Insurance (20)	3.9	0.50						
Computer Automation (24)	–0.9	–0.11						
Natl Convenience Stores (25)	1.5	0.20						
American General Ins—			165.5	6.60	2	31⅝	4.8	4.9
Lincoln American (41)	1.5	0.06						
Service Corp Intl (20)	1.3	0.05						
Richmond Tank Car (10)	0.6	0.02						
ASARCO—Revere Copper & Brass (33)	8.5	0.28	259.1	8.56	3	54	6.3	6.5
Bangor Punta—Lone Star Inds (7)	3.1	0.64	29.7	5.95	10	25½	4.3	4.8
Bendix—ASARCO (21)	25.5	1.11	162.6	7.10	16	49	6.9	8.2
Borg-Warner—Hughes Tool (21)	11.0†	0.51†	166.6†	7.76†	7	39⅞	5.1	5.5
California Portland Cement—Conrock (34)	0.9	0.22	29.3	6.95	3	42¾	6.2	6.4
Callahan Mining—KRM Petroleum (29)	0.2	0.03	20.1	3.42	1	34	9.9	10.0
Chessie System—Natl Mine Service (24)	0.6	0.03	120.5	6.05	1	29¼	4.8	4.9
Clabir—General Host (12)	1.1E	0.28E	2.7E	0.70E	41	5⅜	7.7	12.8
Consolidated Oil & Gas—RL Burns (45)	–5.4	–1.09	2.1	0.43	—	27	62.8	17.8
Curtiss-Wright—			33.8	4.05	56	27	6.7	15.3
Lynch (19) / Cenco (16)	1.3	0.15						
Kennecott Copper (14)	17.7	2.14						
DeLuxe Check Printers—Data Card (45)	2.5	0.22	38.6	3.37	7	34¾	10.3	11.0
DWG—Wilson Brothers (42)	–1.0	–0.16	5.9	0.81	—	3⅛	3.9	3.2
Farm House Foods—Scot Lad (41)	1.5	0.35	3.6	0.90	41	4¾	5.3	8.6

entire share of GM profits. So, you reported income of $1,004 instead of just $530. The extra $474 was "equity earnings." For you, it was not real income, even though it was being reinvested to work for you over the long term.

Sensibly, you wouldn't count on that extra $474, but a lot of companies that own stock in other companies report equity earnings as though they were income to them. The accountants mandate that they do so, provided their shareholdings equal or exceed 20% of the other companies' stock. You'll find equity earnings on a separate line in many corporate P&L statements. Although they are listed separately, they are taken directly to the famous bottom line. (Dividends, of course, are another matter; they are cash actually received and are counted as investment income. Equity earnings, by contrast, are only a bookkeeping fiction, consisting of the difference between earnings and dividends.)

The prime mover in this smoke-and-fire business was Dr. Henry E. Singleton, chairman of Teledyne. Shortly after the unorthodox Singleton personally took over management of his insurance subsidiary's stock portfolio, he flouted convention by concentrating his investments in a few stocks. His auditors advised him of the accounting consequences of Teledyne's owning more than 20% of the equity of Brockway Glass, Curtiss-Wright, Litton Industries and Reichhold Chemicals. The auditors insisted Teledyne must report on a separate line its proportionate share in these four companies' earnings in Teledyne's operating report. Mind you, the accountants didn't tell Singleton he *could* do this; they said he *must*.

Singleton did not (and still does not) like consolidating any of TDY's earnings from investments because he does not consider equity earnings to be real earnings. He did not like the fact that including equity earnings would unrealistically inflate Teledyne's reported earnings. Still he surrendered to avoid confrontation with his auditors.

The percentage would have been higher—and so would Teledyne's reported earnings—if Singleton hadn't held back his holdings of Walter Kidde and National Can to under 20%. By doing so he avoided having to consolidate his equity holdings in these companies, too. If Singleton bought a mere $16 million more of Walter Kidde and National Can, Teledyne's equity earnings would then jump another $20 million annually, since the

Investor—Investment (% of shares owned)	Equity in earnings/losses: total (mil)	Equity in earnings/losses: per investor's share	Investor's net income: total (mil)	Investor's net income: per share	Equity in earnings as % of total net	Recent price of investor's stock	Price/earnings ratio: based on total earnings	Price/earnings ratio: excluding investment
Grow Group—Guardsman Chemical (20)	$ 0.3††	$ 0.09††	$ 4.9††	$ 1.51††	6%	12	7.9	8.5
Gulf & Western—Amfac (21)	11.0	0.23	227.4	4.62	5	19⅞	4.3	4.5
Hanna Mining—Labrador Mining (20)	11.0E	1.23	54.6	6.14	20	40⅝	6.6	8.3
Hartfield-Zodys—Three-D Depts (20)	0.3E	0.08E	7.2E	1.92E	4	8¾	4.6	4.8
Illinois Tool Works—Computer Products (22)	0.3	0.03	41.2	3.37	1	24½	7.3	7.3
Imasco—Hardee's Food (28)	3.3‡	0.32‡	65.4‡	6.33‡	NA	45	7.1	NA
Katy Inds—HMW Inds (53)	2.6E	0.53E	18.0E	3.30E	14	13½	4.1	4.9
Kemper Corp—Gibraltar Financial (25)	2.9	0.24	83.2	6.82	3	27½	4.0	4.2
Walter Kidde—EDO (23)	0.7E	0.07E	84.1	7.85	1	35⅞	4.6	4.6
Leasco—Reliance Group (3)	0.7‡‡	0.45‡‡	1.2‡‡	–0.89‡‡	54	32½	def	def
Masco—Braun Engineering (42)	0.2	.01	73.1	2.80	—	26	9.3	9.3
McIntyre Mines—Falconbridge Nickel (37)	38.7	16.26	36.5	15.33	106	98¼	6.4	def
Monogram Inds—Craig Corp (35E)	0.5	0.18	16.2	5.78	3	46	8.0	8.2
NVF—			70.0E	0.90E	18	7⅛	7.9	9.8
APL (24)	–0.3E	–0.00E						
Burnup & Sims (23)	1.2E	0.02E						
National Can (24)	11.5E	0.15E						
Power Test—Alpha Portland (33)	1.2††	0.57††	5.4††	2.61††	22	22	8.4	10.8
Reliance Group—			217.2	23.33	4	64	2.7	2.9
Imperial Corp of Amer (25)	7.9	0.86						
Rothschild Investment Trust (22)	1.0	0.11						
Reynolds Metals—Robertshaw Controls (27)	2.3E	0.12	177.1	9.25	1	37	4.0	4.1
St Louis-San Fran Ry—NM/Ariz Land (51)	0.5	0.19	19.8	7.47	3	69	9.2	9.5
Schlumberger—Rowan Cos (22E)	6.1E	0.05E	658.4	5.18	1	112	21.6	21.8
Sears, Roebuck—			843.0E	2.65E	1	16⅜	6.2	6.3
Coldwell, Banker (21)	2.7E	0.01E						
De Soto (31)	2.9E	0.01E						
Roper Corp (39)	3.8E	0.01E						
Southern Union—Supron Energy (28)	4.4E	0.66E	34.8	4.88	13	36¾	7.5	8.7
Standard Oil (Calif)—AMAX (19)	63.7	0.37	1,785.0	10.44	4	79½	7.6	7.9
Sun Chemical—Chromalloy American (23)	10.0†	2.21†	34.3†	7.58†	29	27¼	3.6	5.1
Superior Oil—McIntyre Mines (53)	17.9E	0.85	200.3	9.52	9	174½	18.3	20.1
Taft Broadcasting—Kinder Care (20)	0.4	0.04	30.6	3.52	1	29¾	8.5	8.5
Teledyne—			372.0	27.59	12	145¼	5.3	6.0
Brockway Glass (29) Curtiss-Wright (32) Litton Inds (25) Reichhold Chemicals (21)	44.0	3.26						
US Filter—Koehring (23)	2.7	0.33	22.5	2.01	12	15	7.5	8.9
Walco Natl—Leesona (24)	0.3	0.16	7.8	3.57	4	22⅛	6.2	6.5
Williams Cos—BancOklahoma (21)	1.1	0.04	69.5	2.55	2	33½	13.1	13.3

*Estimate for 1979 based on current holdings. †Pro forma estimates for 1979 based on current holdings. ††Latest 12 months. ‡Pro forma estimates for latest 12 months based on current holdings. ‡‡Pro forma estimate for 1979 based on current holdings; Leasco earnings per share after deducting preferred dividends. E Estimate. NA Not available. def Deficit.

magic 20% ownership mark would have been surpassed.

The game that Singleton is playing reluctantly, others have begun to play eagerly. Borg-Warner CEO James F. Beré is swapping a division of his company to Hughes Tool for Hughes stock, raising Borg's Hughes holdings from 16% to over 20%. The swap will permit Borg to take in over $11 million of Hughes' 1980 earnings into Borg's total profits. Borg's 1980 earnings, which would otherwise have dipped from 1979, will now hold up or even increase, and the stock temporarily jumped 8%. But what has really changed? The reality is, a division has been shifted from one company to another. More smoke out of the chimney, with less operating fire.

Borg is hardly alone. Some companies have made a practice of triple-counting earnings by applying equity accounting principles. The case of Kennecott to Curtiss-Wright to Teledyne is a prime example. Curtiss-Wright owns 14% of Kennecott but consolidates 14% of earnings even though it is below the 20% mark. Thus Teledyne, which owns 32% of C-W, must consolidate the Kennecott equity earnings, too.

Have the accountants, once again, in attempting to clarify matters, ended by confusing them? Perhaps. The table on pages 100 and 101 shows some companies with equity earnings in their bottom line. It shows the current price/earnings ratio, first in terms of *reported* earnings, and then with the equity earnings filtered out. In some cases the differences are major. Does the inclusion of equity earnings mislead investors into capitalizing earnings that are not real? Smoke, after all, is not the same thing as fire.—*Maria Latorraca and Stephen Gilbarg*